

VZCZCXRO4824
RR RUEHDBU RUEHLN RUEHVK RUEHYG
DE RUEHYE #0251/01 0640628
ZNR UUUUU ZZH
R 050628Z MAR 07
FM AMEMBASSY YEREVAN
TO RUEHC/SECSTATE WASHDC 5022
INFO RUCPDO/USDOC WASHDC
RUEATRS/DEPT OF TREASURY WASHDC 0493
RUCNCIS/CIS COLLECTIVE
RUEHAK/AMEMBASSY ANKARA 1220
RUEHIT/AMCONSUL ISTANBUL 0548
RUEHLMC/MILLENNIUM CHALLENGE CORP

UNCLAS SECTION 01 OF 03 YEREVAN 000251

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E.O. 12958: N/A

TAGS: [ECON](#) [EFIN](#) [EAID](#)

SUBJECT: HOW LONG CAN THIS GO ON? ARMENIA'S CONTINUED DOUBLE-DIGIT GROWTH

REF: A) 06 YEREVAN 269 B) 06 YEREVAN 1105

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SUMMARY

¶1. Armenia's economy continued its significant expansion in 2006, with GDP up by 13.4 percent, the fifth consecutive year of double-digit growth. As in previous years, construction, much of which is funded by remittances, was the primary driver of growth, up by 37 percent and accounting for 26 percent of total GDP. Declines in diamond and industrial production, however, and the striking appreciation of the dram, up almost 19 percent against the dollar in 2006, pose significant challenges. Both the Armenian government and IMF are predicting more modest growth in 2007. END SUMMARY.

GDP GROWS 13.4 PERCENT LED, AGAIN, BY CONSTRUCTION

¶2. For a fifth consecutive year, Armenia's GDP grew at double-digit rates, up by 13.4 percent in 2006 to approximately USD 6.4 billion (AMD 2,665,036.6 million). GDP per capita in 2006 was approximately USD 1,989. As in the past four years, construction was the main driver of growth, expanding by 37.2 percent year on year, accounting for 26.7 percent of overall GDP. The total volume of construction was USD 1,497.72 million, 90.6 percent of which was privately financed. International assistance also contributes to the on-going construction boom. Activities in real estate accounted for 49.6 percent of total construction, 14.4 percent was in transportation and communications sectors, 11 percent in electric power, gas and water production and distribution. Eighty-two percent of construction was in Yerevan. While exact numbers are not available, it is likely that remittances, estimated to be equivalent to 25 percent of GDP, are funding a large portion of construction sector growth. Remittance flows are difficult to measure and have been described by Armenian Central Bank officials as a form of "second-hand Dutch disease" leaving the economy extremely vulnerable to external shocks (ref B).

¶3. Agricultural output grew by 0.4 percent in 2006 and accounted for 17.7 percent of GDP at approximately USD 1,336.17 million. Services were the second largest contributor to GDP growth, with trade and public catering up by 11.7 percent (accounting for 1.2 percentage points in GDP growth and 10.2 of total GDP).

¶4. The jewelry sector saw a significant contraction in 2006, down by 24.3 percent due primarily to decreased global demand

for diamonds, increased competition from Asian countries and deficiencies in workforce training. Overall industrial output was down by 1.1 percent and tobacco production was also down by 5.1 percent.

PRICES INCREASE

15. Annual inflation in 2006 (December 2006 compared to December 2005) was 5.2 percent, due to higher energy and food prices, while average inflation over the course of the year was 2.9 percent. The producer price index was up by 0.9 percent and the price index in construction rose by 6.9 percent. Agricultural product prices rose by 11.9 percent.

DRAM APPRECIATION

16. The Dram appreciated sharply against the US Dollar in 2006 and was valued at 364.64 AMD to the dollar in December 2006, up by 18.9 percent compared to December 2005. The average AMD/USD exchange rate for 2006 was equal to 416.04 AMD, compared to 457.69 AMD in 2005. According to the Central Bank of Armenia and the IMF significant dram appreciation resulted from strong growth of remittances, increase in productivity and incomes, de-dollarization, and the general global weakening of the US dollar. While some critics continue to claim that the Central Bank has been manipulating the dram exchange rate, increased remittances remain the most persuasive explanation for this situation (ref B).

REVENUES AND EXPENDITURES INCREASE

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17. According to preliminary data from the Ministry of Finance and Economy (published by the National Statistical Service), budget revenues for 2006 were approximately USD 1,056.68 million, up by 17.9 percent compared to 2005 (calculated in terms of local currency). Expenses totaled USD 1,093.59 million, an increase of 15.1 percent compared to 2005. The budget deficit was USD 36.91 million. Tax revenues grew by 18.2 percent in 2006 and reached USD 864.62 million, thanks largely to increased VAT collections (up 13 percent) and increased income tax and corporate profit tax (up by 33.3 percent and 40.3 percent respectively). Tax revenues accounted for 81.8 percent of total budget revenues and the tax to GDP ratio was 14.4 percent.

18. Expenditures on education and science increased by 20 percent to USD 169.55 million, and health expenditures were up by 18.2 percent equal to USD 86.44 million. The share of science and education expenditures and health expenditures in the GDP remained low at 2.6 percent and 1.3 percent respectively.

FOREIGN TRADE DEFICIT EXPANDS

19. During 2006 total trade turnover grew by 15.2 percent reaching USD 3,198.3 million, with exports equal to USD 1,004 million and imports equal to USD 2,194.3 million. The trade deficit grew by 44 percent to USD 1,190.4 million. Exports grew a modest 3.1 percent and imports were up by 21.8 percent. Excluding diamonds, exports grew by 6.7 percent. Export of mining products (comprising 14 percent of total exports) increased by 45.9 percent. Armenia's main trade partners were Russia (13.3 percent of total trade turnover), Germany (9.2 percent), Belgium (7.2 percent), Israel (6.1 percent), Ukraine (5.9 percent) and the USA (5.4 percent). Exports of precious and semi-precious stones and metals (accounting for 31.9 percent of total exports) declined by 4.7 percent. Exports of non

precious metals (28 percent of total exports) and food products (9.5 percent of total exports) declined by 12.8 percent and 1.6 percent respectively.

FOREIGN INVESTMENTS GROW

¶10. Foreign investment reached USD 297.43 million for JanuaryQ September 2006 (up 31.8 percent compared to the same period in 2005) of which Foreign Direct Investment (FDI) accounted for USD 149.04 million (up 8 percent). FDI inflows were primarily in telecommunication (23.7 percent of the total), mining (23.4 percent of the total) and air transport (16.4 percent of the total). During JanuaryQSeptember 2006, FDI from Greece accounted 23.7 percent of total FDI, followed by Germany (23.2 percent) and Argentina (19.8 percent). FDI from the US was 17.59 million and was mostly in IT and hotel services. Russian Vimpelcom's purchase of Armentel in November 2006 for USD 440 million and possible investments in the mining sector in 2007 will likely lead to a significant increase in the Russian share of overall FDI next year.

EMPLOYMENT AND WAGES INCREASE

¶11. According to the National Statistical Service unemployment was 7.4 percent in 2006, down from 8.2 percent in 2005. International organizations, however, believe the unemployment rate is much higher than official statistics suggest (ref A). According to the official figures, 65.2 percent of unemployed were between ages 31-50, 15.6 percent between ages 23-30 and 71.7 percent of unemployed were women. Average monthly nominal wages for January Q November 2006 were AMD 62,477 (approximately USD 150), a 22.8 percent increase compared to the same period of 2005 and 4.2 times greater than the minimum wage. The highest average wages were in the financial (USD 450) and mining sectors (USD 323).

COMMENT

¶12. Many observers were surprised that Armenia was able to sustain its impressive double-digit GDP growth in 2006. The construction sector boom, the primary driver of growth, cannot be sustained indefinitely and both the IMF and the Armenian

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government are predicting more modest (9 percent) GDP growth in ¶2007. The substantial appreciation of the Armenian Dram has also raised serious concerns, particularly among exporters who fear the exchange rate will negatively impact their competitiveness. While the Armenian economy has had an impressive run over the past five years, it is becoming increasingly clear that this is unlikely to continue indefinitely.

GODFREY